RECEIVED Jan 4, 1980

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RUNL News

Vol. 59 No. 15 December, 1979 (ISSN 0149-4163)

Business in Nebraska BB

Published once in June and July, twice in May and Aug., 3 times in Jan., Feb., Sept., Oct., Nov., and Dec., 4 times in April, and 5 times in March by the University of Nebraska-Lincoln, Dept. of Publications Services & Control, 209 Nebraska Hall, Lincoln, NE 68588. Second-class postage paid Lincoln, Nebraska.

Prepared by the Bureau of Business Research
College of Business Administration

THE EFFECTS OF USURY CEILINGS

During the last fifteen years there have been recurrent conditions in financial markets that have caused state governments to review both the levels and effects of their usury laws. Since 1966 there have been four tight-credit periods during which interest rates have reached successively higher levels. During each of those periods, those states with effective usury ceilings which are lower than the general level of interest rates have experienced noticeable shortages of credit and the corresponding adverse impact on their economies. It is generally believed by economists that there is a close relationship between restrictive usury ceilings and the supply and allocation of credit within a state; available empirical evidence tends to support this belief. It is the purpose of this article to consider this issue and to discuss other salient issues concerning usury ceilings.

Usury ceilings are a form of price control, that is, an attempt by a governmental unit to impose the maximum price (interest rate) that may be charged for a commodity or service (credit). Legal ceilings usually are set at levels that are higher than the rate established by the market. As long as this condition prevails, the price of credit will be determined by the supply and demand for funds, and usury ceilings are not an effective force in the credit market. In most states this lack of effectiveness existed for several decades preceding the late 1960s, and usury laws were not generally regarded as a serious problem. Beginning with the tight credit conditions of 1966 and the significant upward movement in the price level, it was recognized that usury ceilings were adversely affecting both the volume of credit available within states and its allocation among the different sectors of the state's economy. Comparable events were repeated and intensified during the credit crunches of 1969-70 and 1974-75. In each instance, most states amended their usury statutes to permit higher legal rates of interest. In a few states such changes require lengthy constitutional amendments; where such constraints exist, there is little question that they have had adverse effects on the local economies. The result has been that usury ceilings have been repeatedly raised, or adjusted in some manner, during the past few years in most states. While each increase was established at a ceiling above the prevailing market rate to provide some degree of flexibility, the changes in many states have proven to be inadequate in the current economic environment, and they are once again under review.

In the United States there has been no national usury ceiling since the colonial period. With the establishment of the Republic, each state has had the prerogative of establishing its own usury laws. As a result, there are numerous differences in state statutes in terms of exemptions as to size and type of loan, covenants of the loan contract, penalties for violations, as well as the ceiling. Since each state's economy is a small segment of a larger national economy and since financial transactions may move freely across state boundaries, one state may make its own financial transactions more or less attractive than those of its neighbors. Credit is perhaps the most mobile of all commodities, and its movement responds very quickly to significant differences in the terms available. The inevitable consequence is a disruption in the normal financial transactions within the state with the restrictive ceiling.

In addition, no state can escape the effects of national economic policies, particularly monetary policy. During the periods of high rates of inflation, tight credit markets are inevitable, and markets are characterized by increasing interest rates as lenders add an inflation premium to protect their real rates of return. If tight credit markets are accompanied by a restrictive monetary policy, as is apparently true presently, interest rates will be pushed upward even further, at least for as long as the policy exists. For these reasons, the market rates of interest will periodically exceed the usury ceilings and limit the availability of credit within the state.

Religions and ethical arguments have historically been used to justify the existence of usury laws. More recent arguments have tended to be slightly less moralistic in tone and placed within the context of their economic significance. The most frequently cited arguments for usury ceilings are those discussed below.

1. They are necessary to protect the small, unsophisticated borrower who would otherwise be subjected to excessive rates by the lender. This argument has two aspects: First, the borrower is assumed to be uneducated and naive, and unaware of the most fundamental technical aspects of financial transactions. Therefore, he must be protected from his own foolish behavior. Second, the borrower will be systematically enticed by the lender into paying rates higher than he thinks he is paying, that is, unconscionable rates; in this instance he must be protected from the lender. If this type of argument ever had any validity, it is redundant in all states today because of the "small loan" statutes which exist.[1] It is clear that the borrowers to whom such arguments apply are those small borrowers who are seeking credit for consumption purposes.

2. It has been argued that usury laws are necessary to restrain the monopoly power of the lender. The lender is assumed to have disproportionate market power over the borrower. This assumes that since there are more borrowers than lenders, the latter's greater resources result in the charging of excessive rates of interest. Thus, some form of protection (Continued on page 2)

(Continued from page 1) for the borrower is essential to balance the bargaining position. This argument seems to be accorded the greatest degree of validity by the proponents of usury laws. Whatever its merit in the past, it appears to have very little applicability in complex economic and financial systems. The typical borrower has many alternative sources of credit from various types of financial institutions and from the money and capital markets. Consequently, the pervasiveness of monopoly power is questionable, and in those instances where it exists it is more likely to result in some form of credit rationing which is made necessary by an arbitrary price control.

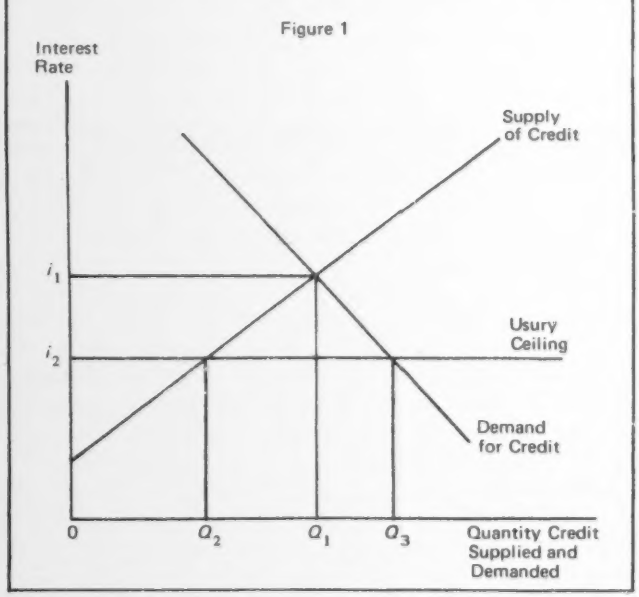
3. It is contended that low usury ceilings will promote higher levels of consumption and investment and thereby a higher level of economic growth and development. This proposition is unassailable if it leads to lower interest rates. However, it has little relevance if usury ceilings are below the market rates, because there will not be adequate credit to support the higher level of economic activity. It is the recognition of this relationship between the credit needed to support a higher level of economic activity that has caused states to consistently adjust their usury ceilings upward.

The remainder of this article attempts to evaluate the merits of these arguments.

The effects of interest rate ceilings depend primarily on two factors: (1) the level of the ceiling and (2) the types and sizes of loans exempted from the ceiling. These two factors determine the applicability of the ceiling. The closer the ceiling is to the market rate, the smaller its impact on credit flows, and the larger and more varied the exemption, the less its effect. However, to the degree that it is effective, there tends to be a shortage and misallocation of credit. The following simplified graph may be used to demonstrate these effects of ceilings (Figure 1).

In this graph the usury ceiling is below the market rate of interest, i_1. If the market rate had been permitted, the quantity of credit supplied at i_1 would have been the amount $0Q_1$. However, since the lender must abide by the ceiling rate, i_2, the volume of credit that is withdrawn from the market is the difference between $0Q_1$ and $0Q_2$, or Q_2Q_1. There are borrowers who are willing to accept funds at the existing market rate but who are prohibited from doing so by the legal ceiling. At this artificially low rate, there are an excessive number of demanders of credit who are not effective in the market because the quantity Q_1Q_3 will not be available in any case. This group could have their demand accommodated only if the supply of credit were increased, which is the opposite of what is likely to occur.

Figure 1



The graph demonstrates two clear immediate results when the usury ceiling is below the market rate of interest. The volume of credit supplied to borrowers is reduced and whatever volume is supplied will be rationed among the available borrowers. Why will the volume of available credit decline? Mainly because the lenders will have numerous uses for their funds in areas and instruments that are not subject to the ceilings. Another reason is the high cost of funds for the lenders. Financial institutions purchase the bulk of their lendable funds and the rates charged on their loans must reflect these costs. For example, most of the funds purchased by banks, savings and loan associations, credit unions, PCAs, etc., are short term and will reflect money market rates. During periods of restrictive credit policies by the Federal Reserve these rates will be very high; recently the cost of these funds has exceeded the usury ceiling in Nebraska. Obviously, financial institutions have neither the ability nor will to continue to lend under such circumstances. If this is true, one might ask why lenders would supply any volume of funds at the restrictive usury ceiling rates? There are two main reasons: First, lenders have loan commitments that may have been made some time ago and which are legally binding. These commitments and lines of credit will be honored. Second, all lenders have customers with whom they have had long-standing and mutually desirable relationships. These relationships are not tenuous and the lender is likely to consider the long-run profitability of the association. Financial institutions are usually willing to serve these customers for a time, but not indefinitely, and probably at loan limits smaller than the borrower needs, desires, or to which he has become accustomed.

There is another effect of usury ceilings that is important. The lender will engage in various kinds of nonprice credit rationing; this will occur even among the borrowers that it wishes to accommodate. This involves making the terms of the loan contract more restrictive. For example, the lender will demand greater collateral, larger compensating balances, service charges, reducing the maturity of the loan, and the like. All of these restrictive clauses of the loan contract have the effect of reducing the risk factor associated with the loan which permits a lower than normal rate. It also has the effect of eliminating from the market those borrowers that are unable to make the contract adjustments; these are apt to be those borrowers for whom usury ceilings are designed to protect and who have fewer alternative sources of credit.

Ceilings that are set at levels below the market rate have an impact on all types of lending, but because of exemptions to their applicability they are most visible for real estate loans to which they apply. There have been several studies conducted dealing with the effects of ceilings on this market and there seem to be two clear results. First, marginal borrowers are quickly rationed out of the market. This is true because the lenders are not permitted to charge above average rates that are required to compensate

for the additional risks inherent in the loans. These borrowers will typically be younger people who have fewer funds for higher down payments, less affluent borrowers that have fewer financial assets, and purchasers of homes in neighborhoods where there is an expectation of greater than normal depreciation. In general, these are the types of borrowers usury laws are designed to protect; however, the type of protection afforded is questionable, because it normally results in their receiving no credit rather than less expensive credit.

The second effect is that residential mortgage lending in the state with the low usury ceiling will decline relative to a state where the ceiling is not a barrier. A corresponding effect is also a reduction in activity in the construction industry because abundant credit is essential to sustain an expanding building industry. It seems clear that all aspects of the residential building and mortgage markets are affected in an adverse manner when restrictive usury ceilings are present.

There are several alternatives available to a state as to the type of action it may take regarding its usury statutes. Some of these alternatives are discussed below.

1. The state may simply abolish its general usury statutes. At least two states have taken this action and it is being discussed in several others. The central question resulting from this action is whether lenders are able to take undue advantage of borrowers without some type of usury ceiling. The evidence seems to indicate that there is adequate competition in the financial markets to protect the borrower from abuse. One study conducted in five metropolitan areas where the ceiling was above the national average does not suggest that local lenders immediately raise the rates to the ceiling but are restrained by the national average. These results appear to be consistent with a competitive and mobile financial market. There are numerous other studies which indicate that interregional interest rate differentials are the result of demographic factors, transaction costs, degrees of risk, and the like, rather than excessive market power of the lenders.

If lenders were free to arbitrarily impose rates on borrowers without regard to market forces, it seems odd that they did not do so during the years prior to the late 1960s. For decades prior to this period, usury laws were consistently above the rates actually charged and mortgage lenders charged rates substantially below the usury ceilings. This suggests that lenders are not immune from the normal market forces, and that the predominant factors determining interest rates are the supply and demand for loanable funds. Nevertheless, most states have chosen not to eliminate their usury statutes but to adjust them in some manner to reduce their effects.

2. Since 1974 several states have adopted a floating usury ceiling. That is, they have tied their usury ceilings to some other interest rate. It was believed that this type of change would be a permanent solution to the problem of recurrent changes in the ceilings. However, despite setting the floating ceiling at a level above the chosen rate, the unusually high interest rates of 1979 have forced many states to consider further changes. This condition is always a threat unless the ceiling is permitted to float at such a high level that it is ineffective, that is, well above the market-determined rate.

There are three problems associated with a floating rate that may cause it to be disruptive. First, to what interest rate should the usury ceiling be tied? Several states have chosen the Federal Reserve discount rate. One reason for using this rate is the ability of nationally chartered banks to tie the maximum rates they may charge to the discount rate. National banks may charge 100 basis points (that is, one percentage point) above the discount rate or charge the state usury ceiling, whichever is greater. During tight money periods this creates a competitive advantage for national banks over state-chartered banks and savings and loan associations, which is a situation that many states have tried to alleviate. Despite its widespread adoption, the discount rate is perhaps the most undesirable rate to use. It is not a market-determined rate; it is administratively set by the Federal Reserve and has historically lagged well behind the market-determined rates. For example, until the last few months it had never exceeded 8 percent and during 1974 there was a difference between the discount rate and the federal funds rate of more than 500 basis points. The Federal Reserve has been more willing to increase the discount rate during the current tight money period (it is currently 12 percent), but it is still an administrated rate which lags the market. In addition, if state usury laws were tied to the discount rate at any reasonable differential, it would encourage the Federal Reserve to consider the impact of its actions on state economies.

Other states have used long-term bond rates as the base for their floating ceilings. Logic would seem to suggest that this might be a more desirable alternative. However, during periods of tight credit policies the yield curve will be sloping downward, that is, short-term rates are higher than long-term rates. It will be the short-term rates that are most closely related to the cost of funds for lenders and will be a more important factor in their willingness to extend loans to their customers. Consequently, during periods of inflation and tight credit conditions when usury ceilings are most apt to be a barrier to lending, a floating ceiling tied to longer-term instruments is unlikely to provide much relief; this is certainly true at the present time.

Tying a floating ceiling to short-term rates provides no better alternative as a permanent solution. While it would be a more desirable choice under the present economic conditions, one cannot assume that a downward-sloping yield curve will exist indefinitely. It is expected that eventually credit markets will weaken and inflation will be reduced, at least to more reasonable levels. Under such conditions, short-term rates will be far lower than long-term rates and lenders might find the difference plus the amount of the float inadequate to compensate for locking in their funds for longer maturity loans, such as residential mortgages and term loans to noncorporate borrowers. The only real way of assuring an effective formula tied to the short-term rate would involve a floor as well as a ceiling on the magnitude of the float in order to permit lenders an opportunity to earn the necessary liquidity premium.

If a floating rate tied to some market rate were desired, the simplest and most desirable alternative would appear to be some intermediate rate, for example, the 3-5 government security, accompanied by a float of several hundred basis point variation.

A second problem associated with the floating ceiling is the size of the differential required before adjustments in the ceiling are permitted. That is, how close to the ceiling must the chosen rate be before it is permitted to be (Continued on page 5)

Review and Outlook

The level of economic activity in Nebraska rose slightly in August, with two of the five sectors showing gains when compared to July. The state's index of real output, which had declined in the two previous months, increased 0.2 percent from its July level and was 0.4 percent above its value of last year. The value of the index was 41.3 percent above its 1967 base-period level.

The August increase was due primarily to an increase in the agricultural sector, where activity rose 7.0 percent, after declining sharply last month. Moreover, prices received by Nebraska farmers in August were 17.1 percent higher than prices in August, 1978. With higher prices and excellent harvests, it seems likely that increasing agricultural cash receipts can be expected to provide some stimulus for the Nebraska economy during the remainder of 1979.

In contrast to the strength of the agricultural sector, the nonagricultural sectors have exhibited considerable weakness during the last few months. The composite index of the four nonagricultural sectors was down 0.7 percent during August, the third consecutive monthly decrease and the fourth decrease in 1979. The July-to-August changes in the nonagricultural sectors were: government, +0.3 percent; distributive, -0.4 percent; manufacturing, -1.6 percent; and construction, -3.7 percent.

Nineteen of the twenty-six reporting cities registered gains relative to August, 1978. This growth was achieved through increases in retail sales, employment, and power consumption. (See tables on page 5 for additional data.)

Notes for Tables 1 and 2: (1) The "distributive" indicator represents a composite of wholesale and retail trade; transportation, communication and utilities; finance, insurance, and real estate; and selected services. (2) The "physical volume" indicator and its components represent the dollar volume indicator and its components adjusted for price changes using appropriate price indexes—see Table 5, page 5.

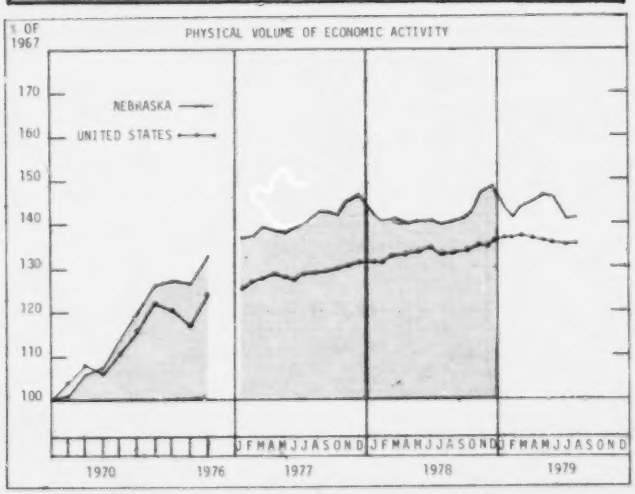
ECONOMIC INDICATORS: NEBRASKA AND UNITED STATES

1. CHANGE FROM PREVIOUS YEAR

August 1979	Current Month as Percent of Same Month Previous Year		1979 Year to Date as Percent of 1978 Year to Date	
Indicator	Nebraska	U.S.	Nebraska	U.S.
Dollar Volume	113.3	112.4	114.3	113.1
Agricultural	128.3	120.6	128.0	125.5
Nonagricultural	111.3	112.1	112.3	112.7
Construction	96.0	107.3	100.9	112.5
Manufacturing	117.1	115.8	118.1	116.7
Distributive	110.4	111.7	111.6	111.9
Government	112.6	107.4	110.9	107.5
Physical Volume	100.4	100.9	101.5	102.3
Agricultural	109.6	107.4	103.5	106.6
Nonagricultural	99.2	100.7	101.2	102.1
Construction	85.1	95.0	88.5	98.7
Manufacturing	104.5	102.9	106.5	105.2
Distributive	98.8	99.9	100.9	101.2
Government	97.8	101.2	99.2	100.7

2. CHANGE FROM 1967

	Percent of 1967 Average	
Indicator	Nebraska	U.S.
Dollar Volume	321.2	302.9
Agricultural	292.2	299.6
Nonagricultural	326.2	303.0
Construction	314.2	285.7
Manufacturing	378.8	296.5
Distributive	317.0	313.5
Government	294.7	282.0
Physical Volume	141.3	135.7
Agricultural	121.8	125.9
Nonagricultural	144.7	136.0
Construction	115.5	105.0
Manufacturing	162.5	128.2
Distributive	143.4	141.8
Government	136.3	142.3

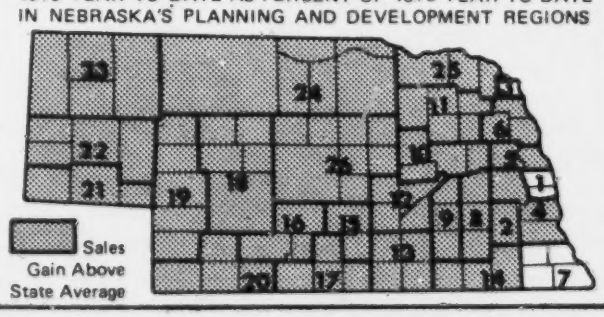


3. NET TAXABLE RETAIL SALES OF NEBRASKA REGIONS AND CITIES (Adjusted for Price Changes)

Region Number[1] and City	City Sales[2]	Sales in Region[2]	
	August 1979 as percent of August, 1978	August 1979 as percent of August 1978	Year to date '79 as percent of Year to date '78
The State	104.5	103.2	101.4
1 Omaha	110.2	106.1	97.3
Bellevue	95.6		
2 Lincoln	104.4	102.3	101.5
3 So. Sioux City	85.0	90.5	93.9
4 Nebraska City	87.3	99.6	102.8
5 Fremont	104.8	101.4	103.1
Blair	90.4		
6 West Point	114.1	101.1	107.3
7 Falls City	99.3	102.9	100.9
8 Seward	94.3	100.6	103.1
9 York	108.0	103.0	108.3
10 Columbus	104.6	100.7	106.5
11 Norfolk	109.3	105.9	105.5
Wayne	102.8		
12 Grand Island	103.9	104.4	105.1
13 Hastings	108.8	106.1	102.2
14 Beatrice	105.7	105.9	104.8
Fairbury	116.6		
15 Kearney	113.0	110.6	106.1
16 Lexington	92.6	102.0	106.9
17 Holdrege	100.0	101.3	103.9
18 North Platte	103.2	100.4	105.8
19 Ogallala	88.4	91.1	105.4
20 McCook	107.8	104.3	104.7
21 Sidney	98.3	95.1	102.2
Kimball	92.2		
22 Scottsbluff/Gering	110.1	105.5	105.0
23 Alliance	92.8	96.0	103.6
Chadron	91.9		
24 O'Neill	106.7	107.6	112.4
25 Hartington	117.9	106.5	104.7
26 Broken Bow	118.3	109.9	110.6

[1] See region map below.
[2] Sales on which sales taxes are collected by retailers located in the state. Region totals include motor vehicle sales; city totals exclude motor vehicle sales.
Compiled from data provided by Nebraska Department of Revenue.

1979 YEAR TO DATE AS PERCENT OF 1978 YEAR TO DATE IN NEBRASKA'S PLANNING AND DEVELOPMENT REGIONS



(Continued from page 3) increased. In addition, are the increments in the float to be broad or narrow, say, 50 or 100 basis points at a time? Also, the speed must be determined with which the adjustments will be made; for example, if the key rate increases this week, how much time must elapse before the ceiling floats upward or downward? None of these questions is easily answered, and the concept of a floating usury ceiling is not a simple solution to the problem.

3. A third alternative is to retain a fixed usury ceiling, but broaden the types of loans that are declared exempt. Most states that have a fixed ceiling have declared loans to corporations exempt, while others have also established loans beyond a certain size not subject to the legal ceiling. This makes the ceiling less effective and thereby less disruptive to the state's economy. But here again, it may reduce the availability of credit for those individuals that usury ceilings are designed to protect. It is the small, personal borrower that will see his sources of credit eliminated, or he will be forced to a higher priced form of credit, that is, he will be compelled to seek a lender with the authority to charge a rate higher than that charged by more traditional lenders.

In summary, it is my judgment that general usury ceilings should be abolished, or if retained, they should be set or permitted to vary at a high enough level to avoid encumbering the availability of credit. This judgment is not made on the assumption or contention that higher interest rates are socially or economically more desirable than lower rates. The empirical evidence leads one to conclude that ceilings simply do not accomplish the objectives for which they are designed, and when they are below the market rate of interest they have their worst impact on both potential borrowers and the state's economy. If these observations were not fairly obvious, state legislatures would not subject themselves to debating such a sensitive topic each time the usury ceiling becomes effective.

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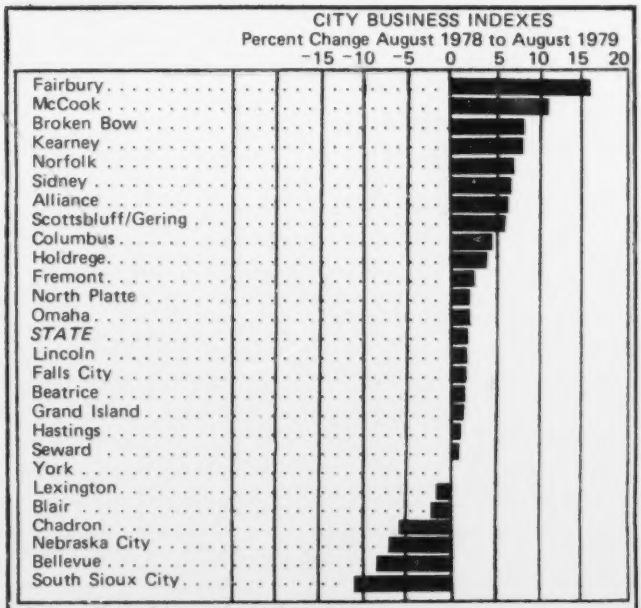
[1] As the desire for consumer goods became commonplace after the turn of the century, state usury laws were a cumbersome obstacle to obtaining consumer credit. These small loans were unprofitable at the permitted rates and an illegal market arose which was onerous and unconscionable. Most states by the 1920s had adopted some form of small loan law that permitted the lending of limited amounts for certain types of loans at rates that far exceeded the general usury statute. Since banks made few of these types of loans, various types of finance companies were chartered by the states to accommodate this need. Today they are most commonly referred to as personal loan or finance companies. In reality, most states have two usury ceilings: one that applies to small loans and another that is regarded as the general usury ceiling.

5. PRICE INDEXES

August 1979	Index (1967 = 100)	Percent of Same Month Last Year	Year to Date as Percent of Same Period Last Year*
Consumer Prices	221.1	111.8	110.6
Commodity component	212.2	112.1	110.8
Wholesale Prices	238.1	113.1	111.4
Agricultural Prices			
United States	238.0	112.3	117.6
Nebraska	240.0	117.1	123.3

*Using arithmetic average of monthly indexes.
Sources: Consumer and Wholesale Prices: U.S. Bureau of Labor Statistics; Agricultural Prices: U.S. Department of Agriculture.



Source: Table 3 (page 4) and Table 4 below.

4. AUGUST CITY BUSINESS INDICATORS

The State and Its Trading Centers	Percent of Same Month a Year Ago: Employment[1]	Building Activity[2]	Power Consumption[3]
The State	100.6	95.4	100.9
Alliance	126.1	47.0	119.7
Beatrice	99.6	95.9	94.4
Bellevue	94.8	37.0	101.9
Blair	97.4	66.6	144.7
Broken Bow	99.1	136.3	94.9
Chadron	98.5	51.8	110.2
Columbus	98.8	199.2	100.9
Fairbury	100.7	323.0	140.1
Falls City	99.1	129.5	110.9
Fremont	102.9	94.3	97.0*
Grand Island	103.7	77.8	92.5
Hastings	103.1	48.5	92.3
Holdrege	99.4	293.4	90.6
Kearney	106.5	111.9	94.5
Lexington	101.8	94.4	109.9
Lincoln	97.7	122.2	99.7
McCook	100.1	240.3	136.9
Nebraska City	101.2	58.1	105.9
Norfolk	100.5	154.7	110.4
North Platte	106.3	82.6	90.1
Omaha	94.8	97.5	100.8
Scottsbluff/Gering	102.0	85.1	118.7
Seward	100.4	208.7	94.5
Sidney	106.4	297.4	100.2
So. Sioux City	93.2	75.5	93.6
York	101.1	37.6	105.6

[1] As a proxy for city employment, total employment for the county in which a city is located is used.
[2] Building Activity is the value of building permits issued as spread over an appropriate time period of construction. The U.S. Department of Commerce Composite Construction Cost Index is used to adjust construction activity for price changes.
[3] Power Consumption is a combined index of consumption of electricity and natural gas except in cases marked * for which only one is used.

Source: Compilation by Bureau of Business Research from reports of private and public agencies.

THE IMPACT OF RESTRICTIVE INTEREST RATES: CASES OF TENNESSEE AND ARKANSAS

Tennessee and Arkansas have had constitutional provisions restricting interest rates to 10 percent during the 1970s. Arkansas still has a 10 percent ceiling, which is considered one of the most restrictive in the United States since it allows for *no* exceptions. Tennessee's law is more flexible, and following a 1977 court case it has been vigorously enforced.

Since these two states are neighbors and since their economies are somewhat similar in structure, it is possible to gain an understanding of the probable consequences of interest rate ceilings by examining conditions in credit markets in these two states. Some of the general effects may be applicable to other states with interest ceilings, including Nebraska.

A study by the Bureau of Business Research at Memphis State University compared credit markets and conditions in Arkansas and Tennessee over the period 1967 through 1976. There was sufficient variation in interest rates over the interval—from less than 4 percent to over 13 percent in the federal funds rate—to provide a test of the ceiling's effect under different market conditions. Space considerations in this issue permit only a brief review of the Memphis study results.

As long as interest rates were below the state's 10 percent ceiling, banks had no difficulty meeting Arkansas's business credit needs. Once interest rates began to bump and exceed the ceiling, however, Arkansas had a marked reduction in the rate of business loan activity. Arkansas became a net exporter of money. The same pattern persisted in Tennessee.

An examination of the federal funds flows illustrates the effect of ceilings. When the interest rate ceiling was exceeded, Arkansas placed $203 million out of the state in the federal funds market, five times the normal amount. Capital is extremely mobile among the states, partly due to the well-developed correspondent banking network.

Nowhere is the impact of an interest rate ceiling more significant than in the consumer loan segment of the market. The ceiling on interest rates in Arkansas has completely eliminated the consumer finance industry in that state.

Interest rate ceilings have also been alleged to have an adverse impact upon consumer prices. Retailers are forced to offer credit at, say, 10 percent but may pay out-of-state creditors 12 percent or more. This differential has been alleged to have increased consumer prices by as much as 5 percent in Arkansas.

The evidence is substantial that interest rate ceilings have a negative impact upon economic development, that money flows out of states with ceilings when the market rates of interest exceed those levels, and that consumer credit is adversely affected. It is ironic that the consumers are the largest losers, since interest rate ceilings are frequently supported on the contention that low interest rates help the consumer. Low interest rates are alleged to help the consumer in that they reduce the cost of debt. Another argument for low interest rates proclaims that ceilings restrict the volume of consumer credit and thereby avoid consumer overextension.

A close scrutiny of the evidence, however, indicates that interest rate ceilings frequently have adverse consequences for the consumer. Consumer credit users are young persons with low incomes and high credit demands. These consumers usually have a low level of liquidity, and a higher degree of risk is associated in loaning to this group. Restrictive credit markets eliminate the higher risks and lower-income consumers.

It is important not to lose sight of a very basic point: the interest rate is a price established in a market. Like any other price, the function of the interest rate is to provide information or signals to producers and consumers and when necessary to perform the rationing function of allocating available funds. When interest rates are artificially restricted and not allowed to respond to market conditions, they can no longer perform their function of information and allocation of available funds.

Restricting interest rates only eliminates credits to certain consumer sectors; it may impede economic development in an area; and, if market rates rise well above ceilings, can lead to a net outflow of funds from a state. High interest rates reflect high rates of inflation, and the best insurance to protect consumers from high interest rates is to insure low rates of inflation.

DONALD E. PURSELL

UNL News

BUSINESS IN NEBRASKA

PREPARED BY BUREAU OF BUSINESS RESEARCH

Member, Association for University Business & Economic Research

Business in Nebraska is issued monthly as a public service and mailed free within the State upon request to 200 CBA, University of Nebraska–Lincoln 68588. Material herein may be reproduced with proper credit.

No. 423 December 1979

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